

U.S. BANKRUPTCY COURT  
NORTHERN DISTRICT OF TEXAS

THE DATE OF ENTRY IS  
ON THE COURTS DOCKET  
TAWANA C. MARSHALL, CLERK

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September 30, 2004. After hearing and considering the evidence, testimony, and argument of counsel at trial, the court took the matter under advisement.

## **I. BACKGROUND**

Pursuant to the Stipulations, the parties agreed:

1. the properties relevant to this dispute are located in Tarrant County, Texas, and Johnson County, Texas (the “Properties”);
2. between March 2002 and November 2002 (the “time period”), Defendants were officers and directors of Dissmore Enterprises, Inc. (“DEI”) and were actively involved in the management and operation of DEI;
3. during the time period, DEI placed orders with Plaintiff for lumber and materials for the benefit of DEI;
4. at the time DEI placed the respective orders, DEI owned each of the Properties for which DEI placed the orders for lumber and materials;
5. during the time period, Plaintiff provided to DEI lumber and materials related to the Properties totaling approximately \$297,000;
6. during the time period, DEI paid to Plaintiff significant additional amounts for lumber and materials delivered to various other DEI construction projects;
7. DEI (as owner of the Properties) borrowed and received from various lending institutions \$2.264 million in construction loans (the “Loan Proceeds”) for the purpose of improving the Properties through loans secured by liens on the Properties;
8. DEI paid to Plaintiff approximately \$75,000 of the Loan Proceeds for lumber and materials delivered to the Properties;
9. DEI paid to other vendors/creditors (excluding Plaintiff) approximately \$324, 000 of the Loan Proceeds in connection with the Properties;
10. at the time Defendants filed bankruptcy, DEI owed Plaintiff for unpaid invoices totaling approximately \$222,000<sup>1</sup> for lumber and materials delivered to the Properties;

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<sup>1</sup> Calculated at trial to actually be \$217,596.63.

11. at the time Defendants filed bankruptcy, DEI owed other vendors/creditors (excluding Plaintiff) approximately \$764,000 for unpaid invoices in connection with the Properties;
12. from the Loan Proceeds, various lending institutions paid approximately \$709,000 for lot draws on the Properties directly to other vendors/creditors and did not deposit said funds into DEI bank accounts;
13. the Loan Proceeds received by DEI during the time period constituted “trust funds” under section 162.001(b) of the Texas Property Code;
14. DEI and Defendants were “trustees” of the trust funds under section 162.002 of the Texas Property Code;
15. Plaintiff was a “beneficiary” of the trust funds under section 162.003 of the Texas Property Code; and
16. DEI and Plaintiff stipulated to the authenticity of, but not the relevancy of, construction contracts, deeds of trust, and security agreements between DEI and various lenders pertaining to the Properties, as well as costs of the title company.

Based on testimony and documentary evidence received at trial, the court considers certain other facts germane to its decision. First, of the funds advanced in connection with the Properties, DEI made to Plaintiff payments substantially in excess of \$297,000. Second, Plaintiff required DEI to pay older invoices related to projects<sup>2</sup> other than the Properties, and funds advanced by banks to DEI in connection with the Properties and paid to Plaintiff were thus credited against amounts due Plaintiff by reason of prior deliveries. Third, the funds advanced by banks for work on the Properties were not maintained in separate accounts but were commingled with other funds, including deposits of Defendants’ personal funds, in a single operating account, from which account all payments to Plaintiff were made.

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<sup>2</sup> Plaintiff would have ceased deliveries to DEI had any invoices remained open beyond sixty days. DEI had the choice, therefore, of using what funds it had to pay those older invoices or doing no further business with Plaintiff. The latter option would have forced DEI to cease doing business.

## II. DISCUSSION

In Count One of the Complaint, Plaintiff alleged that Defendants' failure to pay Plaintiff's unpaid invoices totaling approximately \$222,000 from the Loan Proceeds constituted a violation of Defendants' fiduciary duties as trustees of the trust funds to which Plaintiff was a beneficiary. Consequently, pursuant to the provisions of Bankruptcy Code<sup>3</sup> section 523(a)(4),<sup>4</sup> Plaintiff asks this court to declare nondischargeable Defendants' indebtedness reflected by the unpaid invoices. In Count Two of the Complaint, Plaintiff alleged that Defendants controlled the trust funds as trustees in a fiduciary capacity and that Defendants' subsequent failure to pay Plaintiff's unpaid invoices from the Loan Proceeds was willful and malicious. Plaintiff therefore seeks in the alternative a declaration that Defendants' indebtedness is nondischargeable pursuant to Code section 523(a)(6).<sup>5</sup> Finally, in Count Six of the Complaint,<sup>6</sup> Plaintiff asks this court to

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<sup>3</sup> 11 U.S.C. §§ 101-1330 (2004) (hereafter referred to as the "Code").

<sup>4</sup> A discharge under . . . this title does not discharge an individual debtor from any debt . . . (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.

Code § 523(a)(4)

<sup>5</sup> A discharge under . . . this title does not discharge an individual debtor from any debt . . . (6) for willful and malicious injury by the debtor to another entity or to the property of another entity.

*Id.* § 523(a)(6).

<sup>6</sup> In Counts Three, Four, and Five of the Complaint, Plaintiff initially also sought a determination of nondischargeability of Defendants' indebtedness pursuant to sections 727(a)(2), 727(a)(3), and 727(a)(5). At trial, however, Plaintiff acknowledged it could not prove the section 727 claims and had therefore abandoned them. The court cannot help being concerned by a creditor that invokes Code section 727 in connection with an effort principally directed at excepting just that creditor's debt from discharge. While in the case at bar there is no evidence that Plaintiff intended its section 727 claims as tools for negotiating a settlement for only its benefit, such a tactic is sufficiently suspect and inappropriate that the court would admonish creditors against accepting the fiduciary obligations necessarily coupled with assertion of general objections to discharge unless they are prepared to pursue those objections to discharge. Were the court's decision different here, further inquiry into Plaintiff's conduct might be appropriate.

award attorneys' fees and costs reasonably incurred by Plaintiff in connection with Plaintiff's prosecution of this adversary proceeding.

As a threshold matter, in actions to determine dischargeability of a particular debt under section 523(a) of the Code, "the creditor seeking to have its debt excepted from discharge bears the burden of proof." 4 COLLIER ON BANKRUPTCY ¶ 523.04 (15th ed. rev. 2004). *See also Coburn Co. of Beaumont v. Nicholas (In re Nicholas)*, 956 F.2d 110, 114 (5th Cir. 1992) (finding that federal law places the ultimate burden on the creditor to prove that the debt falls within the Code's exceptions to discharge); *Lampman v. Lee (In re Lee)*, 230 B.R. 810, 814 (Bankr. N.D. Tex. 1999) (same). The law is also well settled that exceptions to discharge should be strictly construed against the objecting creditor and liberally in favor of the debtor to further the Code's purpose of affording debtors a fresh start. *See In re Nicholas*, 957 F.2d at 113 (affirming that exceptions to discharge are narrowly construed against the creditor and in favor of the debtor); *Boyle v. Abilene Lumber, Inc. (In re Boyle)*, 819 F.2d 583, 587 (5th Cir. 1987) (same); 4 COLLIER ON BANKRUPTCY ¶ 523.05 (15th ed. rev. 2004) (same).

Here, Plaintiff claims that Defendants, acting as trustees in a fiduciary capacity, engaged in fraud and defalcation and caused willful and malicious injury to Plaintiff by misapplying the Loan Proceeds in violation of the "Texas Construction Trust Fund Statute"<sup>7</sup> thus rendering the debt nondischargeable under the Code. Based on the relevant provisions of the Statute, the parties agree, as does this court, that Plaintiff was a "beneficiary"<sup>8</sup> of the Loan Proceeds which

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<sup>7</sup> TEX. PROP. CODE ANN. §§ 162.001-162.007 (2004) (hereafter referred to as the "Statute").

<sup>8</sup> An artisan, laborer, mechanic, contractor, subcontractor, or materialman who labors or who furnishes labor or material for the construction or repair of an improvement on specific real property in this state is a beneficiary of any trust

constituted “trust funds”<sup>9</sup> held by Defendants as “trustees.”<sup>10</sup> The court disagrees, however, that the Statute’s characterization of Defendants as trustees of the trust funds elevates Defendants to the status of fiduciaries subject to the provisions of Code section 523(a)(4).

As was true for the Court in *In re Nicholas*, this court is bound by the conclusion that the Statute “creates fiduciary duties encompassed by [Code section] 523(a)(4) *only to the extent* that it defines wrongful conduct under the [S]tatute.” *In re Nicholas*, 956 F.2d at 113 (emphasis added) (citing *In re Boyle* wherein the Fifth Circuit determined that even though “section 162.001 of the [Statute] does flatly state that construction funds are ‘trust funds’ . . . we find no decision of this Court or any Texas court holding that the [Statute] creates the sort of *true trust* required for application of the debt discharge exception of section 523(a)(4)” (emphasis added)). It should also be noted that the *In re Nicholas* Court specifically declined to follow *Capital Aggregates, Inc. v. Waters (In re Waters)*, 20 B.R. 277 (Bankr. W.D. Tex. 1982), which held that the Statute created a trust for purposes of the debt discharge exception of the Code. *Id.* Rather, the Fifth Circuit specifically concluded that “[u]nder § 523(a)(4), ‘fiduciary’ is limited to

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funds paid or received in connection with the improvement.

Statute § 162.003.

- <sup>9</sup> (b) Loan receipts are trust funds under this chapter if the funds are borrowed by a contractor, subcontractor, or owner or by an officer, director, or agent of a contractor, subcontractor, or owner for the purpose of improving specific real property in this state, and the loan is secured in whole or in part by a lien on the property.

*Id.* § 162.001(b).

- <sup>10</sup> A contractor, subcontractor, or owner or an officer, directors, or agent of a contractor, subcontractor, or owner, who receives trust funds or who has control or direction of trust funds, is a trustee of the trust funds.

*Id.* § 162.002.

instances involving express or technical trusts.” *Tex. Lottery Comm’n v. Tran (In re Tran)*, 151 F.3d 339, 342 (5th Cir. 1998) (citation omitted). Although the parties and the court agree that the Statute characterizes Defendants as “trustees” of the construction fund “trust” at issue herein, the court finds that the Statute does not create the type of express, technical, or other trust which creates fiduciary duties encompassed by the debt discharge exception of section 523(a)(4) of the Code.

Thus, because Code section 523(a)(4) excepts from discharge debts for fraud or defalcation only “while acting in a fiduciary capacity,”<sup>11</sup> the “essential element” of this court’s inquiry, like that of the *In re Nicholas* court, is “determining what *fiduciary* duties are imposed on the fund holder and the manner in which the state’s statutory construction funds ‘trust’ interacts with the Bankruptcy Code debt discharge exception for these debts arising from fiduciary activities.” *In re Nicholas*, 956 F.2d at 113 (emphasis in original). A fiduciary duty is created “only to the extent that it defines wrongful conduct under the [S]tatute.” *In re Tran*, 151 F.3d at 344 (reaffirming that the Statute does not elevate every contractor who accepts construction funds or loans to a section 523(a)(4) fiduciary and does so only to the extent that the Statute defines wrongful conduct). Because misapplication of trust funds under the Statute<sup>12</sup> is

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<sup>11</sup> Code § 523(a)(4).

<sup>12</sup> (a) A trustee who, intentionally or knowingly or with intent to defraud, directly or indirectly retains, uses, disburses, or otherwise diverts trust funds without first fully paying all current or past due obligations incurred by the trustee to the beneficiaries of the trust funds, has misapplied the trust funds.

Statute § 162.031(a) (2004).

subject to criminal penalties,<sup>13</sup> there can be no question that any misapplication of the Loan Proceeds by Defendants would constitute “wrongful conduct” and create a fiduciary duty subject to the dischargeability exceptions of Code section 523(a)(4). *Id.* Therefore, Plaintiff must show that Defendants misapplied the funds by “intentionally or knowingly or with intent to defraud,<sup>14</sup> directly or indirectly retain[ing], us[ing], disburs[ing], or otherwise divert[ing] the trust funds without first fully paying all current or past due obligations incurred by the trustee to the beneficiaries of the trust funds.”<sup>15</sup>

Plaintiff’s Trial Brief argues that Defendants misapplied the Loan Proceeds because the funds were *knowingly* used for expenses not directly related to “*the* project.” Indeed, at trial Plaintiff elicited testimony from Defendant Allen Kennedy Dissmore (“Mr. Dissmore”) that Defendants had failed to use any accounting or bookkeeping system to segregate the Loan Proceeds to ensure that the funds were expended on the specific construction project for which

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- <sup>13</sup> (a) A trustee who misapplies trust funds amounting to \$500 or more in violation of this chapter commits a Class A misdemeanor.
- (b) A trustee who misapplies trust funds amounting to \$500 or more in violation of this chapter, with intent to defraud, commits a felony of the third degree.
- (c) A trustee who fails to establish or maintain a construction account in violation of Section 162.006 or fails to establish or maintain an account record for the construction account in violation of Section 162.007 commits a Class A misdemeanor.

*Id.* § 162.032.

- <sup>14</sup> (1) A trustee acts with “intent to defraud” when the trustee:
- (A) retains, uses, disburses, or diverts trust funds with the intent to deprive the beneficiaries of the trust funds.

*Id.* § 162.005(1)(A).

- <sup>15</sup> *Id.* § 162.031(a).



Defendants received the funds. Rather, Mr. Dissmore testified that the Loan Proceeds were deposited into a general business operating account and checks on the account had been drawn as bills fell due without reference to which specific construction project was involved.<sup>16</sup> The court notes, however, relevant to determination of what *fiduciary* duties were imposed on Defendants and the manner in which the Statute interacts with the Code discharge exception of section 523(a)(4) *vis-à-vis* commingling of funds, that

[t]he [S]tatute contains no provision requiring the fund holder to segregate funds by source and project; it does not prohibit the commingling of funds; it does not bar use of funds provided for one project to pay bills incurred on another project if this is done without an “intent to defraud”; and it does not prohibit a fund holder from paying, without any fraudulent intent, creditors on one project with surplus funds left over from earlier work and then using the funds provided for that later project on still other work. In short, the [S]tatute does not create “red,” “blue,” and “yellow” dollars each of which can only be used for the “red,” “blue,” or “yellow” construction project.

*In re Boyle*, 819 F.2d at 586.<sup>17</sup>

And, while the court is cognizant that the scienter element in *In re Boyle* was evaluated under an *intentional* conduct analysis, the court concludes that the result remains unchanged when the scienter element is analyzed, as urged by Plaintiff, under the Statute’s lesser *knowledge* standard. The *In re Nicholas* Court, having acknowledged that the post-*In re Boyle* amended

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<sup>16</sup> Significantly, Plaintiff made no complaint about DEI’s long-standing practice of paying all bills to Plaintiff from a single account. The court might reasonably infer that Plaintiff knew *all* project funds were deposited into a single account and that payments on prior invoices, upon which Plaintiff conditioned further sales to DEI, were thus made from an account in which “trust” funds were commingled. Given the time periods involved, Plaintiff must have at least suspected funds allocable to a current project were being used to satisfy Plaintiff’s older invoices.

<sup>17</sup> Just as commingled dollars do not retain a project-based character, so, too, that the beneficiary applies trust dollars received other than to bills from the project for which the dollars were loaned does not alter the fact that the test of defalcation is whether a beneficiary receives trust proceeds to which it is entitled, not how those proceeds are applied.

Statute “criminalizes knowing or intentional as well as fraudulent misapplications of trust funds,” *In re Nicholas*, 956 F.2d at 113, nevertheless made clear that *In re Boyle* “still almost precisely describes the [Statute] . . . [and] does not create ‘red,’ ‘blue,’ and ‘yellow’ dollars each of which can only be used for the ‘red,’ ‘blue,’ or ‘yellow’ construction project.” *Id.*<sup>18</sup>

At trial, Mr. Dissmore testified that (1) the Loan Proceeds were deposited into one general operating account; (2) there was no mechanism in place to trace the funds coming in; and (3) the funds were used to pay overhead, miscellaneous expenses, and suppliers’ bills on various construction projects as they came due in order to “hold the business above water.” Therefore, notwithstanding Plaintiff’s requirement that Defendants pay Plaintiff’s oldest invoices first, Mr. Dissmore testified that DEI first paid current invoices on the Properties in order to guarantee continued draws from the Loan Proceeds for completion of the Properties’ projects.<sup>19</sup> Indeed, Defendants testified that they had in fact supplemented the Loan Proceeds with funds from Defendants’ personal 401K retirement account and with the proceeds from the refinancing of Defendants’ home in an attempt to extend the viability of Defendants’ business. Mr. Dissmore also testified that the business constructed no homes for personal or family purposes after the year 2000 and that none of the Loan Proceeds was used for personal purposes. Finally, Mr. Dissmore testified that the checks drawn on the business account made payable to Defendants

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<sup>18</sup> It is notable that had DEI “honored” the rights Plaintiff claims as a beneficiary, paying current invoices but leaving Plaintiff’s past invoices open, the result – cessation of DEI’s business due to Plaintiff’s refusal to supply lumber – might well have led to an earlier bankruptcy for DEI. This would, in turn, have trapped any “trust” funds remaining in the general account. It also would have probably led to Plaintiff being paid less than it was paid (Plaintiff’s payment from “trust” funds for current invoices could not exceed \$297,000; Plaintiff received \$75,000 in payment on current invoices but also was paid approximately \$751,000 from the same “trust” funds on old invoices).

<sup>19</sup> Of the Loan Proceeds at issue in this case, Defendants paid to Plaintiff during the time period approximately \$826,000.

and identified by Plaintiff's expert witness as "not payroll related" were in fact wages, salaries, draws, or repayments of the monies previously loaned by Defendants to DEI.

There is no evidence before the court to show that the Loan Proceeds were knowingly or intentionally misapplied by Defendants or used by Defendants to pay for more than actual expenses or for expenses not directly related to the Properties. *Id.* (determining that debts would be subject to section 523(a)(4) nondischargeability if beneficiary could prove that trustee paid "for *more* than actual expenses or for expenses *not* 'directly related' to the construction . . . project" but affirming that "no criminal penalty attaches to the retention, use or disbursement of funds to pay the trustee's *actual* expenses *directly related* to the construction or repair of the improvement – whether or not such expenses were owed to 'beneficiaries' of the trust fund") (emphasis in original). There is no evidence in the record to suggest that Defendants diverted the Loan Proceeds for their own use or for a frivolous use not connected with the Properties or that Defendants willfully or maliciously caused injury to Plaintiff. Finally, there is no evidence to substantiate any intent by Defendants to defraud Plaintiff of the Loan Proceeds. Thus, Plaintiff has failed to make its case under section 523(a)(6), as well as section 523(a)(4).

To the contrary, the evidence before the court supports Defendants' position that DEI did not use the Loan Proceeds for anything other than expenses directly related to DEI's business (even though not traceable to "the project" as urged by Plaintiff). Moreover, the record indicates that Defendants in good faith determined that creditors would best be served by Defendants' attempts to ensure that DEI remained an ongoing business,<sup>20</sup> including deposit into the business

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<sup>20</sup> This court questions whether a decision in Plaintiff's favor on these facts would be consistent with the public interest and the goals of the Code. The conundrum facing persons like Defendants – a choice between observing "trust" formalities in the use of funds or terminating operations – ought

account of Defendants' personal funds. *Id.* (concluding that "general contractors may use the payments they receive from construction projects to keep those projects going even if in some instances, the beneficiaries are not paid first").<sup>21</sup>

Accordingly, the court (1) finds that Plaintiff has failed to carry its burden to show that Defendants engaged in wrongful conduct under the Statute thus creating a fiduciary duty to which Code section 523(a)(4) would apply; (2) finds that Plaintiff has failed to carry its burden to show that Defendants willfully or maliciously caused injury to Plaintiff under Code section 523(a)(6); (3) declines to declare Defendants' indebtedness to Plaintiff nondischargeable under either Code section 523(a)(4) or Code section 523(a)(6); and (4) denies Plaintiff's request for attorneys' fees. Costs of court shall be assessed against Plaintiff.

**SO ORDERED** this 25<sup>th</sup> day of October 2004.



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DENNIS MICHAEL LYNN  
UNITED STATES BANKRUPTCY JUDGE

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not to be resolved always in favor of business termination, especially when a debtor's choice is engineered in part by the creditor/trust beneficiary. A contractor's freedom to borrow from one job to pay off another is inherent in a statutory scheme that permits commingling of trust dollars and is a necessary part of business for the small builder who cannot always protect against cash flow variations, whether caused, as here, by an economic downturn or by slow-paying customers.

<sup>21</sup> Distinguishing both (1) the Oklahoma Lien Trust Statute which strictly limits the use of construction funds to the project for which the funds were loaned or advanced and expressly prohibits any other use and (2) the Arizona Construction Trust Fund Statute which expressly prohibits the diversion or use of trust funds for any purposes other than to satisfy the claims of beneficiaries from the Texas Statute which has no comparable prohibitions.